LNG facilities and interconnectors: EU legislation and regulatory regime

DTI/Ofgem final views

November 2003

Summary

The DTI and Ofgem's joint initial views paper of June 2003 set out a preliminary assessment as to how the requirements of the new EU gas and electricity Directives and electricity Regulation would be applied to gas and electricity interconnectors and LNG and storage infrastructures once transposed into GB law by July 2004. The EU legislation requires a system of regulated third party access to interconnectors and LNG facilities. It also allows national regulatory authorities to exempt major new infrastructures from these requirements where certain criteria are met, subject to approval by the European Commission.

The document noted that the regulatory regime would need to reflect the default obligations of the EU legislation, which are based on regulated third party access to these infrastructures. The initial view in the paper was that default obligations would comprise, among other things, market-based mechanisms or the publication of tariffs on a non-discriminatory basis, with the tariffs or tariff methodologies approved ex ante by the regulatory authority. There would also be certain rules relating to the offer to the market of capacity rights to access these infrastructures, in particular anti-hoarding mechanisms.

In order to implement the requirements of the Directives and Regulation, the document noted that existing arrangements in relation to LNG and storage in the Gas Act could be amended to incorporate changes as necessary. The paper also set out reasons why a licensing regime would be more appropriate for interconnectors.

The document also noted that EU legislation allows the relevant authority, likely to be Ofgem, to grant exemptions from the regulatory requirements to major new infrastructure projects. The project must satisfy certain criteria stipulated in the Directives and Regulation in order to be eligible for an exemption. The paper set out the initial view as to how Ofgem would apply these criteria in considering any application for exemption. The document noted that projects would be assessed on a case-by-case basis. This would include, among others, making an assessment of competition based on a range of qualitative and quantitative factors taking account of the dynamic and forward-looking nature of markets.

In addition, the assessment would look at the access conditions to the facility in question, including among others the way in which capacity was offered to the market; anti-hoarding mechanisms; and sufficient information provision.

The paper suggested that for the duration of any exemption, an initial reference point of 15 years appeared appropriate, though this could vary depending on the nature of the project. The paper also discussed the option of granting very long term exemptions but with some regulatory safeguards, eg the possibility for the regulator to retain the right to withdraw an exemption in certain circumstances. The regulator could invoke such rights where for example the facility in question was found to be in breach of competition law or certain access arrangements were not operating in a competitive manner.

Finally, the paper noted that in order for Ofgem to receive formal powers to grant exemptions, changes will be required to legislation, which is expected by summer 2004. In the meantime, in order to increase regulatory certainty for infrastructure project developers, it was explained that Ofgem was prepared to consider applications from infrastructure project developers for early guidance on possible exemptions. On 19 September 2003, Ofgem and Dienst uitvoering en toezicht Energie (Dte) (the Dutch energy regulator) published the first such draft application received from Gastransport Services in relation to the Balgzand Bacton gas interconnector, inviting views from respondents as to whether to provide early guidance. The Qatargas II project joint venture involving Exxon Mobil and Qatar Petroleum also anticipates applying for a draft exemption shortly.

Notwithstanding any early guidance issued for these projects and consultation surrounding such guidance, Ofgem would anticipate undertaking a consultation once it had obtained formal powers and the facility in question formally applied for an exemption.

There were twenty one responses to the initial views paper, five of which were marked confidential. All but one respondent expressing an opinion on the overall approach supported a light-touch regime that provided for exemptions from certain regulatory requirements, where market conditions allow. The other respondent, while not ruling out this approach, thought that exemptions should only be granted in exceptional circumstances. Many respondents welcomed the further clarity regarding the proposed approach to assessing the criteria for granting an exemption, in particular, in relation to the competition assessment. They also supported the general principle of early guidance being provided to specific projects regarding the likelihood of the grant of an exemption, though many of these respondents noted the importance of consulting on specific exemption applications.

The initial views paper also included a number of specific questions for consultation. Most respondents expressing an opinion supported the proposed features of the default regulatory regime, though further clarity was requested in certain areas, in particular, the regulation of revenues. There were mixed views on the proposals to license interconnectors, in particular on whether or not it was the most effective vehicle for implementing regulatory requirements. This included questions as to how the proposed regulatory requirements would fit with arrangements for existing interconnectors in particular to Northern Ireland and Ireland, France and Belgium.

A large number of respondents commented on the application of "use-it-or-lose-it" rules or other anti-hoarding mechanisms. Some respondents considered such arrangements unnecessary and/or potentially difficult to apply for LNG or electricity interconnectors and argued, in particular, that such mechanisms could undermine primary capacity holders' rights. Other respondents considered anti-hoarding mechanisms to be important, with a some suggesting workable solutions.

Some respondents supported the requirement for "open season" type arrangements for the sale of capacity, though some LNG developers noted that this condition may not be appropriate for smaller facilities or could jeopardise investment by upstream producers interested in developing "own-use" facilities in order to ensure access to capacity. Some respondents supported loosening this condition where market conditions allow.

Respondents also commented on information provision requirements. In terms of the publication of information, there was a general consensus that a balance is needed between improving transparency in the interests of improving efficiency and competition and protecting the commercial interests of the users of a facility.

In relation to the duration of exemptions and potential re-openers, the general view was that periods exceeding 15 years may be appropriate, though one respondent was concerned that this could entail developers passing most of the risks to the purchasers of capacity. In relation to possible "re-openers", a number of respondents considered that this would cause significant uncertainty. A number of respondents considered that existing powers were sufficient to provide necessary regulatory safeguards and argued that at the very least the powers or rights for Ofgem to withdraw an exemption be tightly defined.

Based on these responses and further discussions with developers, the Commission, and other regulatory authorities, the DTI and Ofgem's final views are

broadly unchanged from our initial views paper. The DTI and Ofgem consider a licensing regime to be the most appropriate regulatory vehicle for interconnection activities, and it is intended that a prohibition on interconnector activities without authorisation by licence or exemption order will be introduced as soon as Parliamentary time allows.

Although it is anticipated that there will be a route to exempt certain infrastructure from the requirement to hold an interconnector licence, in the first instance, all interconnectors between Great Britain and other territories will be captured by the licence prohibition, including for example the existing interconnectors to Belgium, France, Northern Ireland, and Ireland and this would also apply to any relevant expansion of capacity. Importantly an exemption from the requirement to hold an interconnector licence should not be confused with a formal exemption from the default RTPA requirements of the Directive. As it is anticipated that facilities exempt under the Directive will still be subject to certain regulatory requirements, such as information provision, these requirements will remain in any licence.

In relation to the regulated regime, more generally, the DTI and Ofgem would generally prefer a mechanism for capacity to be auctioned, with the regulator approving ex-ante the terms of any auction. The regulated regime could however allow tariffs for interconnector capacity rights to be set and approved ex-ante to ensure that those tariffs met certain regulatory objectives, eg. non-discrimination.

In relation to other regulatory requirements, the DTI and Ofgem continue to believe that the following features are important for regulated and exempt regimes:

- **a requirement to initially offer capacity to market:** it is anticipated that loosening this requirement under the exempt regime would require Ofgem to consider the type of exemption granted to a facility and would of course have to be consistent with the exemption criteria, in particular the competition assessment.

- **Effective secondary trading and anti-hoarding mechanisms:** it will be a requirement for developers to adopt mechanisms that ensure that the maximum capacity at a facility is offered to market. Where these mechanisms are found not to be working, Ofgem will have to consider withdrawing an exemption in all or in part, sufficient to address these concerns.

- **Information provision:** in this document we explain the type of information that should be available to the regulator and/or published. In general, any information published ex-post should not be a concern. More generally, information ex-ante should at least be made available to the regulator. In terms of publication requirements for this information, the DTI and Ofgem consider that there should be an equivalence in the information requirements on LNG and interconnectors as required of similar facilities in gas and electricity markets respectively, for example, generators in electricity or other connection points to the NTS in gas.

In addition, this document sets out final views on the exemption criteria. The outcome of an assessment would be expected to influence the type of exemption granted, in terms of the parts of the regulated regime from which exemptions were granted; the duration of an exemption; and/or the manner or frequency with which withdrawal criteria are assessed.

This paper therefore sets out a number of conditions for the default and exempt regime. As noted above, these provide a generic framework in which to assess particular projects. However, the specifics of the regulation of each facility may differ depending on the precise nature of the proposals. For this reason, the DTI and Ofgem attach significance to individual consultation on particular facilities.

It is important to note that the new EU legislation has not yet been implemented into GB law and that any amendments to GB law which are made in order to do so may be different to those currently envisaged. The views set out in this paper may change if the requisite amendments to GB law prove to be different to those envisaged. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into GB law and views of how the new regulatory regime may operate.

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1. Introduction

1.1. In June 2003, the DTI and Ofgem published a joint initial views document: 'LNG facilities and interconnectors: EU legislation and regulatory regime 60/03 DTI/Ofgem initial views' setting out how the recently adopted EU gas and electricity Directives[1] and electricity Regulation[2] would be expected to be implemented in Great Britain (GB). The underlying objective is to promote competition, efficient trade and security of supply by facilitating investment in new import infrastructure.

1.2. In addition to setting out the possible regulatory regime and the generic circumstances for providing exemptions from certain regulatory requirements, the paper noted that a number of infrastructure developers had specifically requested early guidance as to whether or not their particular project might be expected to receive an exemption. Subject to certain legal caveats, Ofgem was in principle minded to consider issuing such guidance to specific projects as to whether they were likely to receive an exemption once formal legal powers were effective.

1.3. The paper noted that, in advance of implementation and entry into force of those powers, Ofgem is not in a legal position either to exempt certain infrastructure or arrive at a definitive view as to the likely regulatory regime, though the main purpose of the paper was to improve the levels of certainty as far as possible.

1.4. This document therefore gives the DTI and Ofgem's final views. These are based on the initial views paper, responses to that paper and our further discussions with the European Commission, developers and other Member States regulators/ governments currently or likely to be interconnected with GB. The document also sets out how Ofgem proposes to handle the process of providing early guidance (subject to certain legal caveats) to

[1] Directive of the European Parliament and of the Council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC; and Directive of the European Parliament and of the Council concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC

[2] Regulation of the European Parliament and of the Council on conditions for access to the network for cross-border exchanges in electricity.

developers and handling exemption applications on the expectation that it will receive the relevant formal powers.

1.5. It is important to note that the new EU legislation has not yet been implemented into GB law and that any amendments to GB law which are made in order to do so may be different to those currently envisaged. The views set out in this paper may change if the requisite amendments to GB law prove to be different to those envisaged. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into GB law and views of how the new regulatory regime may operate.

1.6. If you wish to discuss any matters in this document with Ofgem, please contact Kevin James telephone 020 7901 7181, email kevin.james@ofgem.gov.uk or Shaun Kent telephone 020 7901 7199, email shaun.kent@ofgem.gov.uk.

1.7. In addition, if you wish to discuss any matters in this document with the DTI, please contact Susan Harrison telephone 020 7215 2778, email sue.harrison@dti.gsi.gov.uk.

2. Timetable

2.1. This document presents the DTI and Ofgem's final views as to how the provisions of the Directives and Regulation are likely to be implemented with respect to the regulation of LNG import facilities and interconnectors. We explain how Ofgem expects to handle exemption applications following the grant of relevant formal powers. This document also explains how Ofgem proposes to handle the process of providing early guidance to developers.

2.2. The DTI is the government department responsible for implementing where necessary this EU legislation. The Northern Ireland Ministry for enterprise, trade and investment will implement this legislation as necessary in Northern Ireland. As the next step, the DTI must take the measures necessary to amend GB legislation in relation to those provisions in the Directives and Regulation where the GB is currently deemed not to be compliant. The DTI has announced it intends to issue a separate consultation paper on the measures needed to implement the new EU legislation. It is anticipated that the DTI's paper will be published in autumn 2003. The DTI does not anticipate consulting on LNG import terminals and interconnectors again but will merely refer to the June paper and this document.

2.3. At the European level, it is anticipated that the European Commission will publish further guidance on particular aspects of the new Directives and Regulation, including exemptions from the third party access requirements of the Directives.

2.4. Alongside the consultation processes set out above, Ofgem also expects to consult on individual applications from developers seeking early guidance on the likelihood of receiving an exemption once Ofgem receives formal powers.

2.5. The first such draft exemption application was received from Gastransport Services for the Balgzand Bacton interconnector (BBL). The application and Ofgem's initial views on the project were published on the Ofgem website on 19 September 2003. The deadline for responses to this application was 17 October 2003.

2.6. This invitation by Ofgem for developers to apply for early guidance should not however be construed as a requirement or necessary formal step prior to

Ofgem obtaining formal powers. Early guidance might for instance be most helpful for developers who need to decide whether or not to proceed with their projects this year or certainly prior to Ofgem obtaining formal powers sometime in 2004. However, it is left to individual developers to decide whether or not to apply. Notwithstanding any early guidance issued and consultation surrounding such guidance, Ofgem would anticipate undertaking a consultation once it had obtained formal powers and the facility in question formally applied for an exemption.

2.7. In terms of consultations for early guidance, Ofgem would expect a consultation period of 4 weeks to issue early guidance once Ofgem has finalised its views. As noted in the initial views paper, the European Commission has a formal role under the Directives and Regulation, and on this basis the DTI and Ofgem have been discussing early guidance with it. Once Ofgem has issued its final views, it will then be for the European Commission to come to a view, if any, on the guidance prepared by Ofgem.

2.8. While we shall aim to ensure, as far as possible, that any potential guidance issued gives comfort as to the likely regulatory treatment of particular infrastructure, any such guidance issued would also be constrained to a significant extent by necessary legal caveats.

3. Background

3.1. The initial views paper provided background, detailing existing and proposed gas and electricity interconnectors and LNG import terminals. The paper also provided further details of current GB legislation as it applies to these infrastructures and further background on the new EU gas and electricity Directives and electricity Regulation that include provisions that apply directly to the regulation of gas and electricity interconnectors and LNG and storage infrastructures.

3.2. In summary, there are at present already a number of gas and electricity interconnectors to / from GB, and LNG storage facilities, but no LNG import facilities. The DTI and Ofgem are currently aware of a range of proposals to construct new interconnector and LNG import facilities.

3.3. Present legislative and regulatory arrangements mean that gas interconnector activities may be licensed under certain circumstances. There is presently no requirement for electricity interconnectors from or to GB to be licensed, and hence little scope for the direct regulation of these infrastructures. The Gas Act 1986 sets out obligations for LNG facilities. All these types of facilities are subject to the general provisions of EU and UK competition and merger law.

Proposed interconnectors and LNG facilities

3.4. Since publication of the initial views paper, the DTI and Ofgem have continued to meet with a number of infrastructure developers and potential users of interconnectors and LNG facilities.

3.5. In September 2003, Ofgem issued an initial views document “Gastransport Services’ (GTS) draft application for an exemption for the Balgzand Bacton Pipeline project”, a proposed gas interconnector project between GB and the Netherlands.

3.6. Interconnector UK (IUK) are currently in the process of installing compression facilities at the Zeebrugge terminal to boost the reverse flow capacity (ie. from Belgium to GB) of the Bacton Zeebrugge interconnector. Initially, two electrically driven compressors will be installed, increasing

capacity to 16.5 billion cubic meters (bcm) per annum. It is intended that these will become operational in December 2005. IUK are currently in discussions for further enhancements to the reverse flow capability of the interconnector, potentially taking flow capabilities to 25 bcm per year by 2006.

3.7. In relation to the proposed North-Sea Interconnector – a joint venture electricity interconnector project planned by National Grid Transco (NGT) and Statnett between GB and Norway - the Norwegian Oil and Energy Ministry announced on 16 September 2003 that it did not support the current plans of the Norwegian grid operator Statnett. The project will not therefore be proceeding at this time.

3.8. Nevertheless, two other electricity interconnectors remain at various stages of planning. One project would link GB to the Netherlands and is planned by NGT with Tennet and potentially other partners. Another link may be constructed to the Republic of Ireland.

3.9. A number of LNG terminals are also under consideration. The details of three of these projects are already in the public domain. There is an NGT project at the Isle of Grain. Two other projects, one planned by Petroplus and the other a joint venture between ExxonMobil / Qatar Petroleum are being considered at separate sites located in Milford Haven, Wales.

3.10. Clearly in setting out a final view on the implementation of the new EU legislation which has yet to be transposed into GB law, and bearing in mind the continued application of competition and other relevant law, it is necessary to emphasise that certain caveats should be attached to this final view. That is, any amendments to GB law which are made in order to implement the EU legislation may be different to those currently envisaged and the views set out in this paper may change if the requisite amendments to GB law prove to be different to those envisaged. Interested parties therefore should not rely on this document for any purpose other than as guidance as to the way in which the new EU legislation may be transposed into GB law and views as to how the regulatory regime may operate.

4. Respondents' views and the DTI's and Ofgem's final views: proposed regulated and exempt regimes

4.1. The DTI and Ofgem's June paper sought views in particular in relation to:

- the default regulatory regime, and in particular the application of use-it-or-lose-it or other anti-hoarding mechanisms;
- how the exempt regulatory regime should differ from the default regulatory regime;
- the assessment of the exemption criteria set out in the Directives and Regulation, particularly those relating to competition issues; and
- the duration and withdrawal of any exemption

4.2. There were twenty one responses to the paper, five of which were marked confidential. Copies of the non-confidential responses are available from the Ofgem library and on the Ofgem website.

4.3. Of those respondents expressing an opinion on the overall approach, all except one supported interconnector and LNG facilities being granted an exemption from certain regulatory requirements where market conditions allow. A number of respondents also welcomed measures to reduce uncertainty by providing early guidance to specific facilities. A number of respondents emphasised the importance of full consultation when deciding whether to grant exemptions.

4.4. Respondents' views on the specific issues raised in our initial views paper are summarised below. This chapter deals with the issues concerning the proposed regulated regimes relating: to tariffs and revenues; the management and allocation of capacity; regulatory requirements retained under the exempt regime; and proposals to license interconnector activities. Chapter five discusses issues concerning the assessment of particular exemption criteria and the duration and withdrawal of any exemption.

Regulated third party access regime

The DTI and Ofgem's initial view

4.5. In our initial views paper, we set out the regulatory objectives, both as a consequence of the new EU Directives and Regulation and the wider requirements necessary to achieve an effective access regime to infrastructure connected to the GB market.

Respondents' views

4.6. Respondents' views on the regulated third party access (RTPA) regime centred around the possible tariff regime, including the extent of regulatory involvement in setting the tariff methodologies, the tariff levels, and the duration of contracts that might be permitted. In addition, a number of other respondents questioned what form "alternative market-based arrangements" that are provided for under the Directive could take under the regulated regime.

4.7. Three respondents were of the view that RTPA should be based upon published tariffs approved ex-ante. One of these suggested that the tariff regime and the modification process should be subject to public consultation. One respondent noted that guidance may be needed as to the prescribed minimum and maximum duration that capacity rights should be sold, since unduly short capacity duration and tariff offers may not be appropriate. On the other hand, this respondent considered that too long a capacity contract could impede the ability of some parties to participate.

4.8. One respondent argued that the default regime should not include requirements for an initial offer of capacity to market nor any use-it-or-lose-it (UIOLI) provisions but that regulatory authorities could introduce these measures if they were found to be necessary. Another respondent noted, however, that the electricity Regulation contains provisions requiring the maximum capacity of interconnectors to be made available to market participants and that netting should be allowed as far as technically possible.

On this basis, any non-allocated capacity should be reattributed to market, in an open, transparent and non-discriminatory manner.

4.9. Two respondents questioned the regulation of revenues, with one respondent interested in the likely level of regulated rate of return that might apply. The other respondent requested further details in relation to the provisions of the electricity Regulation, which requires revenues to be used for specific purposes, in particular as a consideration when setting network charges. This respondent considered this difficult where the interconnector owner/operator may be a separate company to the network operator for the national transmission system.

4.10. Another respondent questioned what form regulation would take once an exemption lapses. The respondent asked whether interconnector activities would become subject to the same form of regulation as the grid, eg. that the capacity should be auctioned. This respondent considered that the revenue could be allocated to specified purposes, one of which would be payment to the original owners but with any surplus above a reasonable rate of return put to the use or uses set out in the Regulation.

4.11. Another sought clarity as to whether RTPA included bilateral agreements or whether an open-season process based on auctions could be considered to be RTPA.

The DTI and Ofgem's response

4.12. There remain two broad options for an RTPA regime either based on published tariffs or auctions.

4.13. The tariff regime could contain provisions for the publication of tariffs and the methodology underlying their calculation. Ofgem would ensure prior approval of the tariffs or methodologies. Based on existing regulatory practice, the relevant objectives for tariffs methodologies would be set out in advance and allow developers to propose methodologies that are best designed to meet those objectives. Similarly, arrangements under existing transmission and transportation licences – whereby transmission companies obtain representation from industry parties prior to submitting final proposals for

tariffs or changes to tariff methodologies to the regulator for approval- would be appropriate.

4.14. More generally, however, the DTI and Ofgem considers that under the regulated regime for interconnectors the most appropriate means to determine the price and allocation of capacity would be through an auction process. The regulatory authority would have an ex-ante role to approve this methodology in order to ensure that it is transparent and non-discriminatory and would expect a suitably diverse range of contracts. In these circumstances, all available capacity should be offered to market on a rolling basis and of suitable duration. The price for capacity would be set by market valuations of that capacity. Published tariffs may however continue to apply for example to recover any operational costs not recovered through the auctions and equally there may need to be approval of reserve prices. Where these are applied, the regulator will need to ensure these are consistent with the promotion of competition and efficiency and avoid undue preference in access to the facility. Auction procedures would also need to include sufficient transparency concerning the basis on which such auctions will be conducted.

4.15. It should be noted that the RTPA regime needs to take account of the ability of the owner to finance its activities and to provide an appropriate allocation of risks associated with such investments. Hence, the RTPA regime could include an "open-season" type process to enable the developer to secure contractual commitments from users provided this is conducted either by auction or based on specific tariffs approved ex-ante. Recalling one respondent's question regarding the forms of open-season possible under RTPA, the DTI and Ofgem consider that, going forward, negotiated bilateral agreements would not appear to be consistent with a regulated regime.

4.16. In relation to the regulation of revenues, as noted in the initial views paper, the RTPA regime under the Directives does not necessarily require the regulation of revenues where market-based arrangements are provided. The Directives also state that the relevant authority has a duty to approve tariffs or at least the tariff methodology. Reference to tariff methodology typically refers to the structure of tariffs, whereas the approval of tariffs in this context appears to be a wider concept relating also to the approval of the overall level

of tariffs, which by definition appears to include regulatory approval of the appropriate revenues and tariff structures.

4.17. Hence, the requirements do not necessarily require the regulation of the rate of return. However, where a regulatory authority decides that it is not appropriate to grant an exemption on the grounds that some or all of the criteria of the Directive are not sufficiently met, in particular where there are concerns that the infrastructure in question enjoys some form of dominant or monopoly position, then the regulatory regime may need to focus on returns. This could arise for instance where there was an undue reliance on one import source to supply gas or electricity. On the other hand, where there is sufficient competition, then the regulation of returns may be unnecessary but this does not prevent appropriate regulation of other aspects of interconnectors and LNG, such as appropriate non-discriminatory RTPA conditions. In any case, due to their nature as stand-alone and more speculative projects, it might be expected that interconnectors could earn a rate of return above the typical 6.25% currently earned for national networks.

4.18. Specifically for electricity interconnectors, in addition to requirements of the electricity Directive, and in the absence of an exemption, the electricity Regulation requires that interconnector revenues be put to one or more uses. This includes guaranteeing the availability of allocated capacity; maintaining or increasing interconnector capacities; and/or as an income to be taken into account by regulatory authorities when approving the tariff methodology. In this respect, if introduced the licences issued to relevant electricity interconnectors will have to reflect appropriately the requirements of the electricity Regulation.

4.19. There were a number of comments regarding distinctions between new and existing infrastructure. The main reasons put to the DTI and Ofgem from infrastructure developers why an exemption under the Directive may be necessary for new investments is that they require, among others, long-term capacity commitments, a level of regulatory certainty, and a higher rate of return to proceed. Nevertheless, there may be existing infrastructure developed on the basis of long-term capacity commitments and where those existing long-term capacity contracts have yet to expire.

4.20. For these projects, where those contracts were used to finance the initial investment, and where previously the capacity was offered to market in a sufficiently transparent, competitive and non-discriminatory manner, then for the relevant remaining duration of such contracts, such primary capacity could be treated as an initial offer to market. Therefore, Ofgem is not in principle minded to consider re-opening the particular tariffs negotiated for such capacity, where we are satisfied that they have already been approved ex-ante, albeit by the previous regulatory arrangements.

4.21. On an ongoing basis, however, once those contracts have expired, Ofgem would anticipate approving appropriate non-discriminatory and transparent methodologies for the sale of capacity. In addition, Ofgem would continue to anticipate subjecting existing interconnector infrastructure to a number of other regulatory obligations including UIOLI and information provision requirements, where these arrangements are currently not in place.

4.22. The treatment of existing interconnectors would also have to be consistent with regulatory arrangements at the non-GB end of the interconnector. In this respect the DTI and Ofgem will continue to take active measures to discuss these issues in particular with the Belgian, Dutch, French and Irish authorities. The preferred overall objective would be to arrive at a reasonably consistent regulatory regime applying across the whole interconnector.

4.23. Some of the other requirements of the regulated regimes are discussed in more detail under separate headings below, as they will also apply under the exempt regimes. These include: a duty always to make unused capacity available to market on an ongoing basis through UIOLI or other anti hoarding type provisions; capacity rules not to impede secondary trading of purchased interconnector capacity; publication of information; and other technical and contractual issues

Minimum requirements of an exempt regime

The DTI and Ofgem's initial view

4.24. Table 1 of the initial views paper highlighted the proposed possible differences between default and exempt regimes. In general, the minimum requirements for an exempt regime included in particular: effective capacity

allocation in terms of an initial offer of capacity to market (though under specific circumstances this condition might be loosened); effective mechanisms to ensure that capacity is not hoarded; and information provision requirements relating both to the regulator and potentially also to market.

Respondents' views

Initial offer of capacity to market

4.25. Four of the seven respondents commenting on the need for developers to demonstrate that capacity had initially been offered to the market said that they believed that "open season" type requirements provide a transparent tool to test the level of interest and competitive access to new infrastructure. Two respondents also noted that such requirements address concerns regarding inappropriate sizing of the facility either to preclude the use by others or to extract higher rents. One of these respondents therefore expressed interest as to whether an "open-season" would be required before or after the capacity of the interconnector was determined.

4.26. Many respondents supported loosening the requirement for an "open-season" where the market is sufficiently competitive. One respondent however noted that it did not agree with an exemption where the open-season criterion had not been met. This respondent therefore welcomed the opportunity for a consultation phase for any exemption request, particularly regarding own-use type facilities.

4.27. One respondent commented that for small projects, the ability to expand capacity may be determined by factors other than third party demand revealed by an "open-season", and that an "open season" requirement therefore may not be appropriate in all cases.

4.28. Three respondents commented that "open-season" procedures could impinge on the development of "own-use" type facilities. One respondent argued that if the facility development was underpinned by investment both at the facility and upstream then the requirement for an "open-season" could prevent the developer obtaining the capacity it needed at its terminal. This in turn could prevent the entire project from proceeding. Another respondent

noted that "own-use" is a different commercial model with different risk profiles and financing implications compared to merchant models. This respondent therefore argued that requiring an operator to handle third party capacity would skew the project financing away from an "own-use" model.

The DTI and Ofgem's response

4.29. The DTI and Ofgem continue to believe that a demonstration of an initial offer of capacity to the market can help support the case in relation to the competition assessment. In this respect, the DTI and Ofgem consider that consultation on a case-by-case basis will be important. A demonstration of an initial capacity offer could address any possible concerns in relation to the sizing of the facility.

4.30. The range of views expressed by respondents, suggests that infrastructure developed solely for "own-use" could also in principle be considered for an exemption even where it had not conducted an open season. Any assessment for an exemption would however need to consider carefully the particular competition effects and the relevant circumstances surrounding the project both in considering either the conduct of an "open-season" or justifying an "own-use" type development. Moreover, the DTI and Ofgem consider that an exemption or the criteria for withdrawing an exemption will be influenced by the presence or otherwise of an open-season. The links between competition and the duration and withdrawal criteria for an exemption are discussed further in chapter 5.

Effective secondary trading of capacity and anti-hoarding mechanisms

4.31. Thirteen respondents commented on anti-hoarding mechanisms such as UIOLI provisions. There were mixed opinions as to whether these provisions were required, although most supported some form of anti-hoarding mechanism. Other respondents argued that there were already sufficient incentives to use capacity or place it back on the market. However, one respondent expressed some uncertainty as to how diligently or effectively developers would act to ensure that all capacity is made available to the market and that secondary trading is maximised.

4.32. One respondent specifically supporting UIOLI mechanisms argued that no reserve prices should be attached to spare capacity offered to the market and that the sale of capacity should be at the relevant auction clearing price.

4.33. A large number of respondents emphasised, in the context of UIOLI, the importance of not unduly impacting upon the rights of primary capacity holders. In this respect, in particular for LNG terminals, a number of respondents welcomed the discussion in the initial views paper regarding potential difficulties concerning UIOLI at LNG terminals due to shipping logistics and storage capacity limitations.

4.34. Two respondents were concerned about the proposals to impose UIOLI in the event that capacity is not made available since it could create risks to upstream investment in LNG. One respondent argued that Ofgem must be satisfied that any such anti-competitive hoarding is taking place before it imposes any UIOLI rules. The respondent also argued that it might be sufficient to refine capacity trading mechanisms to solve any problems without moving to formal UIOLI rules and that the possibility of other import terminals also reduces the risk of capacity hoarding. The other respondent raised concerns that if one party were found to be hoarding and others were not then it would be unfair to impose more stringent UIOLI rules upon other capacity holders. In these circumstances, this respondent argued that it would be better to rely upon competition law.

4.35. A number of respondents suggested possible solutions for UIOLI provisions for LNG import terminals. One respondent suggested non-nominated capacity could be released to the market, noting that a key issue is the notice period a prospective third party receives regarding capacity at a terminal. It argued that a short notice period of a few days is not enough in a market where ships take several weeks to reach market. At the same time, too long a notice period may preclude planned use of the terminal by the capacity holders. A notice period of at least three months should be considered. Another respondent noted however that access by a third party could impinge on the primary holder. If there were a delay to a primary capacity holder unloading its ship then offering “free slots” to market would potentially devalue the primary capacity holder’s rights if there were not sufficient flexibility associated with that capacity. On the other hand, another

respondent suggested that this could be resolved if the use of capacity by a third party did not prevent a scheduled delivery by the firm capacity holder other than with that capacity holder's agreement. Given such a restriction, the respondent said that it did not believe that UIOLI need necessarily undermine the rights of primary capacity holders.

4.36. Another respondent noted that there were examples in the USA of LNG import terminal operators offering interruptible capacity subject to the rights of the firm capacity holder under the terms of contract. The respondent noted however that these were commercial arrangements not necessarily imposed by governing authorities. Another respondent also advocated selling capacity on an interruptible basis, whereas another considered that the concept of interruptible capacity was not technically feasible at LNG facilities.

4.37. As an alternative arrangement, one respondent argued for a non-committed booking process. Under this model, capacity would be booked either on a twelve, six or one month basis prior to the trading date. The party that booked capacity would not enter into a binding agreement until a month before delivery, with capacity relinquished to third parties at this stage if appropriate.

4.38. In relation to interconnectors, two respondents argued that UIOLI could be difficult to implement on electricity interconnectors. One respondent gave the example of a 1 hour gate closure (GC) which would give the primary capacity holder the right to make a nomination 1 hour before electricity delivery. If at GC a party has unused capacity that is only notified at GC, it would be impractical to offer unused capacity to the market at that time. Bringing forward the nomination timetable (ie. further away from GC) would make the regime for interconnectors inconsistent with competing generation and demand.

4.39. Two respondents argued that arrangements should allow for the netting of opposing flows on interconnectors. Indeed, one respondent noted that this was an explicit requirement of the electricity Regulation. The other respondent noted that implementing such netting is difficult in practice because the ownership of a contractual right to capacity does not guarantee that a physical flow to match that capacity will necessarily take place.

4.40. In relation to gas interconnectors, one respondent suggested that the same UIOLI requirements in relation to entry capacity can be applied to gas interconnectors (ie. UIOLI would apply to the system entry capacity but there would be no UIOLI for terminal capacity). Similarly, another respondent considered that the offer of interruptible capacity, where demanded, provides an effective anti-hoarding tool.

4.41. A number of respondents were also interested in the roles and responsibilities connected with monitoring capacity use and sale and which party should ultimately be responsible for ensuring that capacity is released to market. In relation to LNG, two respondents noted that monitoring of any hoarding should take into account the difficulty of defining capacity and use. They noted that use is constrained by a number of factors, including shipping schedules, berthing availability, storage capability and regasification rates. One respondent argued that these may differ between terminals depending on commercial arrangements for terminalling, storage and regasification services actually procured. Monitoring arrangements should therefore be considered on a case by case basis. For monitoring purposes, one respondent argued that this could relate to capacity usage, though in the first instance it could also relate to utilisation of entry capacity.

4.42. One respondent expressed a preference for the regulatory authority to have the right to request information if anti-competitive behaviour is suspected, rather than the introduction of routine monitoring.

4.43. Two respondents said that they believed that it was inappropriate for the LNG terminal operator to have a role to offer to the market unused capacity previously withheld by the primary capacity holder. One of these noted that when trading on a secondary market a shipper would be mindful of operational requirements of a terminal (e.g. timely delivery of spot cargo, gas quality conforms to specification, etc) and would seek to avoid any knock-on effects to the firm capacity holder's subsequent use of the terminal. In this regard, the firm shipper in a merchant terminal and not the owner/operator is best placed to identify the interruptible shipper. Another respondent, however, noted that it may be appropriate as system operator to monitor the extent to which shippers were not using their capacity. This respondent, a potential interconnector developer, said it would consider in the contract with

the original shipper retaining the right to make unused capacity available to the primary market.

The DTI and Ofgem's response

4.44. Based on the responses above, in relation to UIOLI provisions, the DTI and Ofgem consider that there are three broad options:

- Ex ante definition of UIOLI rules;
- Explicit right for the regulator to impose UIOLI if capacity was seen not to be made available to market; and
- For developers to propose their own mechanism, but with an exemption withdrawn or modified in order to amend appropriately the UIOLI rules if they were found not to work.

4.45. The DTI and Ofgem initially considered option 2 but in the light of consultation responses now consider that option 3 most suitable. At the very least each project will need to demonstrate that there is a transparent mechanism that allows spare capacity to be made available to market. The ultimate objective is to ensure that capacity is not hoarded and that unused capacity can be obtained in a transparent market-based manner by third parties so as to maximise the use of the interconnector concerned.

4.46. In our discussions with a range of LNG developers, most have considered it reasonable for an electronic bulletin board to be established to advertise spare slots. The primary capacity holder would retain the right to use its slots. A third party taking up that spare capacity would have to respect relevant rights associated with that spare capacity – for example the relevant time slots, berthing and storage capacities. In relation to concerns that a primary capacity holder would necessarily lose some flexibility where unused slots were offered to market, the DTI and Ofgem consider however that even in the absence of anti-hoarding mechanisms, merchant type facilities would need arrangements in place to govern the use of primary capacity rights and degree of flexibility assigned to each capacity "slot" where there is more than one user. On this basis, it should be possible for facility owners to arrive at a reasonably pragmatic definition of capacity rights that could extend to the capacity offered via a bulletin board or alternative arrangements. Relevant

definition of capacity rights would also need to be established for any own-use facilities on a similar basis.

4.47. Ofgem would require terminal operators to pass information to Ofgem, on the use of capacity against nominations. Where there was evidence that capacity holders were deliberately and knowingly nominating use of their capacity but with a view to hoarding that capacity, Ofgem would need to consider the remedies necessary. On this basis, the exemption allowing developers to propose their own arrangements could be withdrawn, leaving Ofgem to consider alternative arrangements either by amending or requiring a developer to bring forward new proposals to alleviate any capacity hoarding concerns.

Information provision

4.48. The majority of the eight respondents commenting on information provision raised concerns about commercial sensitivity of information and potential impact on individual players, for example users of infrastructure. A number of respondents were interested in the specific information that would be required. One respondent referred to approaches being developed in relation to confidentiality issues within the Madrid Forum's Guidelines for Good Practice, which suggest that aggregate information could be published without jeopardising confidentiality where there are more than three shippers using that facility. One respondent argued that it was unclear why "information should be provided to market enabling participants to evaluate the availability and worth to themselves of interconnector/LNG capacity" given that an interconnector operator will always make capacity available and not impede secondary trading.

4.49. One respondent specifically commented that the exempt regime should also include requirements for publication of relevant information to the market. Two respondents also noted that confidentiality need not preclude rights for the regulator to obtain information.

4.50. More generally, there were mixed views on the extent to which information should be made available to the market. A number of respondents argued that Ofgem should consider publication of information that is consistent with

existing arrangements for example the publication of flows of gas onto Transco's system.

4.51. One respondent expressed less concern with ex post publication and said it did not believe that publication of actual capacity utilisation on an annual basis would pose a problem, they had concerns however with publication of intended use or "real time" flow information. One respondent argued that in order to ensure that anti-hoarding measures can operate effectively aggregate information should be published on capacity utilisation in various timeframes and on real time flows. Similarly, prices charged for use of Interconnectors/LNG facilities should be made available to market players.

4.52. Another respondent argued that if RTPA were chosen or applied, there should be full disclosure in order to demonstrate that no more than a regulated return is being earned. The respondent argued however that where auctions were applied then returns would be determined by the market and full transparency would not be needed other than publication of auction results.

4.53. A number of respondents also argued that further information should be provided so that trading activities can be carried out efficiently, in particular real time information on any loss of an interconnector due to maintenance or other circumstances. In addition to the information suggested in the initial views paper, the respondents suggested publication or collection by the regulator of expected capacity utilisation before the day and up to the day; actual capacity utilisation after the day; prices charged for RTPA – published after the day to give a rapid view of capacity valuation; real time information flows – up to the day and throughout the day.

The DTI and Ofgem's response

4.54. The DTI and Ofgem consider it appropriate that Ofgem has access to information it needs to fulfil its functions. In general, Ofgem would anticipate facility operators collecting and passing to Ofgem information on nominated and actual capacity utilisation. Similarly, information should be made available to relevant TSOs in line with the requirements of network codes and as or when modifications are raised.

4.55. In relation to information provision to the market, the DTI and Ofgem agrees with the suggestion by one respondent that there should be an equivalence in the information required of interconnector and LNG operators as generally required of similar activities in relevant gas and electricity markets respectively. For example, in relation to electricity markets, to the extent that generators are required to make available information or such information is made available on their activities, this information should be similarly available in relation to interconnectors. This equivalence principle should provide a sufficient degree of transparency regarding electricity interconnectors, ensuring that they enable competition on equal terms with generators in GB.

4.56. At the very least, the DTI and Ofgem do not consider there are any concerns with the publication of ex-post information. In addition, any contracts that interconnector and LNG facilities enter into with users must not contain any provisions that prevent the operator of the facility:

- passing that information to the regulator;
- meeting any obligations vis-à-vis the GB transmission system to which the facility connects (including future modifications for example to their transmission system codes); or
- complying with any existing and future requirements to make information available to the market.

Regarding the last bullet point, the DTI and Ofgem consider that pending the completion of a review of transparency of the offshore gas industry, further transparency may be required for example in relation to terminals and upstream facilities; and, on the basis of the equivalence principle, such transparency requirements would be anticipated to extend to interconnectors and LNG terminals. In addition, this provision need not only arise from legal duties but could also be extended to include any voluntary industry agreements to improve transparency for example within the European Madrid and Florence Fora.

Licensing and regulation of interconnectors

The DTI and Ofgem's initial view

4.57. In order to implement the requirements of the Directives and Regulation, the initial views paper noted that existing arrangements in relation to LNG and storage in the Gas Act could be amended in order to make the necessary changes. The paper also set out reasons why a licensing regime may be a more appropriate vehicle for regulating interconnectors.

Respondents' views

4.58. Two of the five respondents specifically commenting on the proposals to introduce a licensing regime for interconnectors supported the proposal. One of these noted that it provided the most efficient and transparent method of regulating such interconnector activities and would ensure consistency with regulation of other areas of the supply chain. Three of the five respondents expressed concerns regarding a licensing regime, with two concerned about how it might apply to existing infrastructures.

4.59. Two respondents questioned how the licensing regime would work in practice. Both noted the different functions of inteconnector owners, operators and developers and suggested that the requirements and obligations on different parties should be clear and unambiguous. One respondent noted possible jurisdictional issues given the reach of any one country's legislation and the way interconnectors operate across and beyond international boundaries. Two other respondents also sought greater clarity as to the particular licensing requirements or relevant legislation parties would be exempted from. In addition, some respondents queried how current arrangements in relation to the Gas, Pipelines and Petroleum Acts would be changed.

4.60. One respondent raised concerns with the licensing regime and noted that the route adopted for storage and LNG facilities under the Gas Act did not require a licensing regime but provided for exemptions to be granted. The respondent noted that the degree of flexibility that the licensing regime provided was also a concern and urged that there were effective checks on the power of the regulator to alter a licence. In particular, the respondent urged that modifications should only occur with the consent of the licensee or via a referral to the Competition Commission. The respondent also

argued that it did not understand the significance of the comment that a licensing regime may be required in order to accommodate differences in market arrangements, as it argued that an interconnector must by definition be compatible with market arrangements at both ends.

4.61. Five respondents, while not directly commenting on the need for a licence, noted however the need for flexibility in the regulatory approach to ensure that there is a consistent regulatory regime in the territories covered by the interconnector. They suggested that this might be achieved by regulators working closely with their opposite numbers to align as far as possible the arrangements applying to the interconnector at both ends. Some respondents urged against an undue increase in regulatory burden, in particular where regulation at the non-GB end of the interconnector already provides for many of the requirements of EU legislation. One respondent in particular argued for a seamless approach to regulation so that one regime governs the regulation of the interconnector asset and operation irrespective of location.

4.62. Other respondents commented on regulatory regimes applying to existing interconnectors, namely those interconnectors to Northern Ireland and the Republic of Ireland, Belgium and France and whether the regulatory provisions and access arrangements already in place complied with the RTPA requirements. Two respondents noted that licensing regimes already applied to the Republic of Ireland and Northern Ireland interconnectors. One of these respondents queried whether the Northern Irish interconnector actually qualified as an interconnector under the definition of the new Directives as it was not between Member States. Two other respondents argued however that there should be common arrangements in place for new and existing interconnectors.

4.63. Another respondent expressed concern at the arrangements already in place on the Scotland-England interconnector. This respondent suggested that similarly open and transparent arrangements that provide for non-discriminatory RTPA should be developed at the earliest opportunity in the event that British Electricity Trading and Transmission Arrangements (BETTA) were delayed. Another respondent queried whether interim

arrangements would be put in place in relation to interconnectors pending BETTA.

4.64. One respondent noted that upstream pipelines could be used to fulfill the role of interconnectors and questioned how interconnectivity via offshore infrastructure would be treated.

The DTI and Ofgem's response

4.65. The DTI and Ofgem consider that the relevant question to address in relation to the responses above is whether an interconnector licence would be the most appropriate vehicle for implementing the Directives and meeting wider regulatory objectives set out in this document.

4.66. As stated in the initial views document, there are a number of reasons why a licensing regime is most appropriate, including the fact that interconnection is more like other activities subject to licensing such as transmission whereas LNG import terminals do not have as many potential interactions. The regulation of interconnectors necessarily potentially interacts with offshore arrangements both in gas and in electricity as offshore windfarms are developed. It is important to take account of the interactions between regulatory regimes for interconnectors and other activities. Importantly, due to their cross-border nature, the regulation of interconnectors necessarily interacts with regulatory regimes and market arrangements at the other end, which suggests the need for sufficient flexibility. In addition, future regulatory requirements in relation to interconnectors are pending but yet to be finalised, for example in relation to new guidelines under the electricity Regulation.

4.67. Therefore the main argument for the licensing of interconnectors is that it enables a sufficiently adaptable regulatory approach. There are difficulties in capturing in a suitably flexible manner some differences between interconnected markets or to ensure that primary legislation can fully anticipate future interactions of interconnectors for example with offshore developments such as wind farms or future EU regulation.

4.68. On the other hand, the flexibility to alter arrangements, which could introduce an element of uncertainty, can be balanced by appropriate governance

arrangements, as apply for existing licensed activities – ie. by agreement of the relevant licensee(s) or by reference to the Competition Commission.

4.69. In relation to the questions regarding what types of activities would be subject to an interconnector licence, under BETTA, the Scotland-England interconnector is to be subsumed into the transmission network, therefore it is not intended that this infrastructure would be subject to interconnector regulation. Similarly, upstream gas pipelines are not intended to be captured by the licence prohibition as these form part of the offshore regime currently regulated by the DTI.

4.70. Although it is anticipated that there will be a route to exempt certain infrastructure from the requirement to hold an interconnector licence, in the first instance, all interconnectors between Great Britain and other territories will be captured by the licence prohibition, including for example the existing interconnectors to Belgium, France, Northern Ireland, and Ireland and this would also apply to any relevant expansion of capacity. Importantly an exemption from the requirement to hold an interconnector licence should not be confused with a formal exemption from the default RTPA requirements of the Directive. As discussed in this chapter, it is anticipated facilities exempt under the Directive will still be subject to certain regulatory requirements, such as information provision and these requirements will remain in any licence.

4.71. Clearly the issue of jurisdiction is important for interconnectors. Hence, as suggested by respondents it is important that regulators and Governments work together to arrive at a reasonably common set of arrangements relating to interconnectors. In this respect, Ofgem has been in discussion with its counterparts in other Member States with the aim of arriving at a common regulatory approach to interconnectors. In particular, for the consultation on the Balgzand-Bacton Interconnector, Ofgem issued, in parallel with the Dutch regulator, its initial views on the project and Ofgem has been in close contact with the Dutch authorities with a view to issuing our final views documents.

5. Respondents' views and the DTI and Ofgem's final views: exemptions criteria

5.1. The initial views paper set out the approach that Ofgem would adopt in assessing a particular exemption application against the criteria set out in the Directives and Regulation:

- the investment must enhance competition in gas or electricity supply and, for gas, enhance security of supply;
- the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted;
- the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built;
- charges are levied on users of that infrastructure;
- the exemption is not to the detriment of competition or the effective functioning of the internal gas or electricity market, or the efficient functioning of the regulated system to which the infrastructure is connected or linked.

5.2. These five exemption criteria are discussed in turn below.

Condition (a): the investments must enhance competition in gas and electricity supply and enhance security of supply

The DTI and Ofgem's initial views

5.3. The initial views paper noted in particular that Ofgem would seek to undertake a forward-looking assessment of the effect on competition of the infrastructure in question on the relevant GB market. The annex to the paper also provided detail on the qualitative and quantitative indicators that could assist in this assessment.

Respondents' views

5.4. Overall, in relation to the exemption criteria, one respondent queried whether an infrastructure project would have to meet one, some or all of the criteria to receive an exemption.

5.5. Four of the five respondents specifically commenting on the competition assessment supported the concept of undertaking such an assessment, with exemptions treated on a case-by-case basis.

5.6. One respondent agreed that the relevant indicators for the assessment of gas markets could include contractual positions at the beach and downstream market, at least for the purposes of the initial exemption assessment. However, this should not mean that subsequent developments in these markets could provide a reason for any "exemption" granted to be reconsidered. In addition, this respondent said that when evaluating downstream and beach markets, Ofgem should explicitly recognise the right of large supply companies to maintain existing market share.

5.7. Two other respondents commented on possible interactions between market participants. One of these said that it believed an important competition issue may therefore include consideration of the parties that the developer may wish to sell to and that there may be less concern, for example if the developer sold only to parties with a market share below the average. The other respondent, a potential interconnector developer, argued that it could not have a role in the competition test, as it would be unable to know to whom the shippers using its pipeline were selling their gas.

5.8. A number of respondents commented that too narrow a market definition would be a concern. One respondent argued that the relevant market was Great Britain, though another suggested that relevant gas markets may extend well beyond individual member states. One respondent argued that any competition assessment should focus on possible substitutes at the "macro level", namely available substitutes to electricity interconnectors such as generation. Micro level considerations (i.e. at the facility type level), for example only comparing competition between interconnectors, could lead to unsatisfactory outcomes when considering the wider objectives of promoting supply diversity through a range of facility types. One respondent noted that

synergies could also exist when different market sectors are considered together, or through possible netting off effects, for example reduced market power through divestment while increasing market power in another area.

5.9. Two respondents emphasised the need to ensure that the assessment was dynamic and forward looking. One in particular noted that the competition assessment should not only look at the market "before" and "after" the infrastructure is added but could be complemented with a second step of a forward-looking "with" or "without" test that considers the project in the context of competing against logical alternative projects or ones that might mitigate a forecast increase in concentration.

5.10. One respondent requested clarification of the concept of "temporal markets" and whether or not it referred to the market for peak supplies or within-day flexibility.

The DTI and Ofgem's response

5.11. The DTI and Ofgem can clarify that each project must to meet all criteria in order to receive an exemption. However, for each individual criterion there may be a number of factors to consider and it may be necessary to analyse all of these factors, in the round, in order to arrive at an appropriate conclusion on each test.

5.12. Clearly there is some difference in the analysis of each criterion since the questions asked by some criteria lend themselves to more definitive answers. For example, for criterion (a) involving a competition assessment, two specific projects could pass the test but one might pass it more clearly than another. In addition for gas, security of supply is also part of criterion (a), which could also impact to an extent on the assessment, though for this criterion it would not be possible to conclude that if a project were good for security of supply but not good for competition that it would pass the criterion, as the Directive requires that a project "enhance competition in gas supply and security of supply". However, for criterion (a), it could be possible for a particular application that at certain point of the supply chain, (eg. upstream, wholesale or downstream markets) that if viewed on its own there would not be particularly strong evidence that the project supported competition in that sector. On the other hand, this application could still, in

principle, pass the competition test, when considered together with other parts of the supply chain, this pointed to the project being beneficial to competition in gas supply.

5.13. Importantly, the extent to which a project meets the criterion could influence the nature of the exemption in terms of duration and other matters. This issue is discussed further at the end of this chapter.

5.14. In relation to specific comments on criterion (a), and linked to the discussion in paragraphs 5.12 to 5.13, the DTI and Ofgem agree that the definition of the relevant market should consider a number of factors and scenarios to account for the dynamic and forward-looking nature of the competition assessment but also to ensure that the definition of the relevant market is neither set too wide nor too narrow. This may include, for example, assessment of the extent to which interconnectors and LNG are able to participate in specific temporal markets, such as peak supplies or within-day flexibility as suggested by one respondent. In addition, in discussions with an LNG developer, it has been put to the DTI and Ofgem that the view expressed in the initial views paper that the gas supply chain should include gas sold at the beach should in fact be widened. This developer considered that for this part of the gas supply chain the wholesale gas market would be more appropriate as beach gas is merely a subset of the wholesale market.

5.15. The possible difficulties surrounding the definition the relevant market reinforce the need for any exemption application a developer submits to include its own competition assessment. In addition any exemption application will be subject to wider industry consultation in order to ensure that there is sufficient information and diversity of views contributing to the definition of the relevant markets and also to ensure that expected future developments can be taken into account.

5.16. As noted above, one respondent suggested that if a new project potentially increased the developer's market power, then a developer could propose to reduce market power concerns in another part of the energy sector for example by undertaking divestments. In reaction to these proposals, the DTI and Ofgem note that it is up to developers to present their case to the authorities for all of the criteria. As mentioned in the initial views paper, there are a range of factors that could help support a competition assessment,

such as an “open-season” or a proportion of capacity being made available to third parties. Hence, a developer may wish in its application to point to alternative remedies. Any assessment made by Ofgem would consider carefully the application on its merits and on a case-by-case basis.

5.17. We discuss later in this chapter questions concerning the basis on which exemptions may be withdrawn in response to market developments, in particular downstream developments that are not the direct responsibility of the developer in question. The DTI and Ofgem consider that in general the regulatory authority should establish, at the outset of a new project, on the basis of a number of market indicators that the nature of the project and the relevant market conditions when taken together across the supply chain are sufficiently competitive to allow the grant of exemptions.

Condition (b): the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted

The DTI and Ofgem’s initial views

5.18. In our initial views paper, the DTI and Ofgem explained some potential differences between onshore networks and interconnector or LNG development. It might be expected, for example, that new infrastructures would be unlikely to be built if the returns are limited to that provided for onshore networks, because the risks for these projects are probably greater than for onshore investment. It would be inappropriate for onshore network customers to bear these greater risks since they may derive little direct benefit from the infrastructure developments. In a competitive market, project developers and the users of the facility would share the risks and any upside returns would be capped by competitive pressures.

Respondents’ views

5.19. In general, most respondents welcomed the recognition of the need to strike an appropriate balance between regulation of activities while accounting for the size and possible risks associated with interconnector and LNG investment. However, one respondent considered that developers would

potentially be able to achieve the necessary return on investment under a default RTPA regime.

5.20. Three respondents expressed concerns that if a developer went ahead without formal approval from the regulator, and the developer signed an agreement for primary capacity rights (or undertook significant sunk investments in infrastructure) prior to the grant of an exemption, the fact that there was now a financial underpinning (sunk investment costs) could jeopardise the granting of an exemption under the terms of this criterion.

5.21. Similarly, one respondent wished to clarify the definition of new and existing facilities under the Directive, in particular that the whole of a facility would be considered where certain investment may have been initiated in anticipation of receiving an exemption.

5.22. One respondent argued that a facility applying an "open season" procedure is likely initially to determine revenues since all capacity will be offered to primary capacity holders. The respondent argued that in the case of higher than expected returns, for instance due to lower running costs, these should not be treated as excessive.

5.23. One respondent noted that there were also risks for upstream developers/shippers who have agreed long-term contracts or made investments upstream to ensure the availability of LNG. There are commercial risks to parties where they are unable to secure relevant capacity at LNG import terminals consistent with their contracted gas.

The DTI and Ofgem's response

5.24. The DTI and Ofgem continue to believe, as discussed in the initial views paper, that the development of potentially risky investments such as interconnectors and LNG infrastructure would not normally fit within the class of infrastructure developments that would ordinarily be allowed to recover costs as part of the Transco or NGC network activity remuneration. In this framework, however, if there were possibilities for investors to recover any upside returns of the project, they should not be protected from possible downside risks of the investment (ie. through recovery of costs on all network users).

5.25. The DTI and Ofgem wish to clarify that new facilities under the definition of the Directive and Regulation are those that were not completed or for which the main financial commitments were made after July 2003 (the date of entry into force of this legislation). Any exemption request would be expected to apply to the whole of the infrastructure and not simply to the uncompleted parts of the facility. To do otherwise would unnecessarily discourage infrastructure developers from committing any funds to a project prior to receiving an exemption.

5.26. The approach to the regulation of existing infrastructure was discussed in the previous chapter. The specifics of regulation will depend on discussions with individual regulators at the other end of the interconnectors. The DTI and Ofgem wish to ensure that a reasonably common set of arrangements emerge in the regulation of interconnectors.

5.27. In terms of concerns that a project's returns were higher than expected, for instance due to lower running costs, Ofgem considers that equally there could be downside risks. Hence, for the duration that an exemption is expected to apply, the facility in question would not be subject to any regulation of revenues.

Condition (c): the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built

The DTI and Ofgem's initial view

5.28. In the initial views paper, it was noted that as part of an exemption request project developers should demonstrate that they are at least legally separate from relevant network operator or operators. In addition, the DTI and Ofgem considered that in terms of general transparency, and minimisation of opportunities for cross-subsidy and discriminatory behaviour is best facilitated where transport facilities such as interconnectors and LNG import terminals are at least legally separate from other upstream and downstream activities.

Respondents' views

5.29. One respondent suggested that exemption requests should be diligently reviewed in particular where the developer in question is also an affiliate or related undertaking to the network operator as in Transco's case of the transfer of Isle of Grain LNG facility. The respondent considered it particularly important that there is no cross-subsidy from regulated network revenue. Similarly, once the facility has been constructed and commercial arrangements have been entered into the respondent argued that there should not be a restriction on capacity held back for network operation purposes. The respondent considered that it was difficult to see how competition would not be undermined for these services if capacity was not offered to market on a non-discriminatory basis, especially if there were no requirement initially to offer through an "open season".

5.30. One respondent noted that clear and unambiguous definition of the respective rights and obligations of infrastructure owners, developers and operators would be particularly important. The respondent considered it important that greater comfort over transparent capacity allocation processes and non-discrimination requirements could be facilitated by separation of ownership and operation activities.

5.31. Another respondent argued that the requirement for interconnectors and LNG facilities to be at least legally separate from other upstream and downstream activities was totally unrelated to the requirements of the Directive. The respondent queried how this condition might relate to "own use" arrangements or why this should be any different to the treatment of generation, where separation from supply interests is not a requirement.

The DTI and Ofgem's response

5.32. The DTI and Ofgem continue to believe that it is important to ensure effective separation of exempt facilities from regulated network regulated activities in order to help to promote effective competition between certain infrastructures. More generally where developers for example are permitted to receive the full returns or losses arising from their investment, they should be prohibited from recovering any losses from the generality of network users.

5.33. The particular ownership and operation structures and the basis on which rights of access are granted to particular facilities are also important. For example, although an "own-use" facility may be permitted where there is a positive assessment of the exemption criteria, it is important that the arrangements surrounding the sale and use either of initially available or spare capacity that may enable third party access to that facility would be handled in an appropriately non-discriminatory manner.

5.34. For this reason, Ofgem would wish to see sufficient separation arrangements from upstream and downstream interests to ensure that the maximum available capacity is offered in a non-discriminatory manner. Such separation will be considered as part of each specific application.

Condition (d): charges are levied on users of that infrastructure

The DTI and Ofgem's initial view

5.35. In the initial views paper, it was noted that infrastructure developers would be required to demonstrate that this criterion was satisfied.

Views of respondents

5.36. Respondents' only comment was the on general need to ensure that no cross-subsidy occurs from network regulated activities.

The DTI and Ofgem's response

5.37. In the context of discussion of condition (c) above and combined with condition (d), the DTI and Ofgem consider that this requirement remains clear and unambiguous. To aid transparency in respect of this criterion, the DTI and Ofgem would wish to see publication of rates paid by primary capacity holders.

Condition (e): the exemption is not to the detriment of competition or the effective functioning of the internal

gas or electricity market, or the efficient functioning of the regulated system to which the infrastructure is connected or linked

The DTI and Ofgem's initial view

5.38. In the initial views paper, we explained that the competition assessment conducted as part of critierion (a) would cover some aspects of criterion (e), in addition this test would need to cover relevant technical issues and ensure the efficient functioning of the systems to which the infrastructure connects. In particular, Ofgem would seek to ensure that interconnector and import terminal operators were bound by relevant technical, safety and contractual rules and responsibilities. In addition, particular market circumstances, for example interactions of different balancing regimes and markets would need to be considered. In this respect, Ofgem would seek dialogue with the relevant authority of the regulated system to which the infrastructure is connected.

Views of respondents

5.39. One respondent noted the ongoing DTI/Ofgem/HSE study announced in a DTI press release in June 2003 into UK gas quality issues. This study will consider the ability of the UK to handle greater variation in gas quality as it becomes a net importer and possible policy responses to handle these variations. The respondent considered that this study needs to progress swiftly particularly to enable LNG import terminals to be developed in a timely and efficient manner.

5.40. Two respondents mentioned the importance of progressing liberalisation across Europe, particularly in the context of greater import dependence. One respondent commented that the UK exemptions regime could set precedents across Europe and therefore that it is important that a rigorous regime is applied that is fair, non-discriminatory and transparent.

The DTI and Ofgem's response

5.41. In relation to gas quality issues, the DTI and Ofgem agree that the DTI/Ofgem/HSE study into UK gas specifications and future import dependence needs to progress swiftly. In this respect, the DTI anticipates reporting on Phase 1 of the study by the end of November 2003.

5.42. In relation to European issues, the DTI and Ofgem fully agree with concerns that liberalisation of European markets has to progress rapidly in particular in light of the UK's greater gas import dependency but also in order to maximise the benefits of trade and supply diversity through greater interconnection. In this respect, both the DTI and Ofgem are actively involved, at a European level, in ensuring that the organisation and completion of the single market in relation to gas and electricity proceeds in the interests of UK.

Duration and withdrawal of an exemption

The DTI and Ofgem's initial view

5.43. In the initial views paper, the DTI and Ofgem set out possible options in relation to the duration of an exemption. It was noted that a necessary balance needs to be struck between granting long and/or guaranteed durations and granting shorter and/or contingent durations. The former has the benefit of giving certainty to investors whereas the latter can help take into account for example limited access conditions to particular infrastructure or better allow for changes in the competitive environment.

Respondents' views

5.44. Seven respondents commented on the duration of an exemption. The majority suggested that a 15 year period was an appropriate starting point but with a case-by-case assessment. Some noted in particular that a more appropriate duration for some projects could be up to 25 years. One respondent questioned however the reference period of 15 years. The respondent noted that the Commission has accepted exclusive access to facilities in excess of 15 years for example for the Viking Cable and Belgium-UK interconnector where 25 years access was approved. The respondent mentioned that the Court of First Instance has reminded the European

Commission that the duration of an exemption must be sufficient to enable the beneficiaries to achieve the benefits justifying such investment.

5.45. One respondent noted that the duration for any exemption may differ for different regulatory aspects. For example, there could be an exemption from the regulation of revenues for a longer period than in relation to specific regulatory rules governing access arrangements.

5.46. All six of the respondents commenting on withdrawal criteria raised concerns about the uncertainty that these could cause. The majority of respondents argued that reopeners should be tightly defined. One respondent suggested that one way to limit the uncertainty could be to rule out making an assessment of the withdrawal criteria for example for the first 10 years of the project.

5.47. A number of respondents considered that the reasons for withdrawing an exemption should relate to the activities of the infrastructure in question. In particular, they argued, the infrastructure should not be penalised for general changes in market conditions, for example the emergence of dominance of a party downstream of that terminal. One respondent suggested that as long as projects do not merge or sell all the capacity or LNG gas in advance it would not be necessary to undertake any further inquiry about the terminal's impact on these markets.

5.48. Two respondents commented on the link made between competition law and possible exemption withdrawal, noting that competition and mergers legislation already provided powers for remedies where parties are found to be in breach.

5.49. Another respondent noted that any indicators that Ofgem uses in the competition assessment should be stable through time. For example, the introduction of new indicators could cause Ofgem to reach different results in its analysis even if the underlying market had not changed.

The DTI and Ofgem's response

5.50. It is clear that respondents favour long term and relatively certain exemptions. Where these exemptions are to be subject to a withdrawal under certain circumstances, respondents favour both clearly setting out in

advance the criteria for prompting the withdrawal of an exemption, and linking withdrawal criteria to the actions of the party subject to exemption rather than to exogenous changes in circumstances.

5.51. Where the criteria for exemption are met or are likely to be met, the DTI and Ofgem also favour granting relatively long term exemptions that are relatively speaking less likely to be reopened. In particular, the demonstration of the existence of effective competition and its likely ongoing prevalence will tend to indicate a longer duration exemption and/or a limited set of reopeners. Where it is less clear that effective competition will prevail, longer durations with a larger set of reopeners or shorter durations with a smaller set of reopeners will be appropriate.

5.52. The DTI and Ofgem consider that the following relevant withdrawal criteria could be appropriate:

i. breach of the exemption criteria given in the Directives and Regulation initiated by direct action of the facility owner or operator

ii. relevant breach of competition law (following any appeals)

iii. bankruptcy of the facility owners

iv. mergers / acquisition activity by the facility owner that change the competitive nature of the infrastructure in question

v. mergers / acquisition activity by players other than the facility owner in question that change the competitive nature of the infrastructure in question

5.53. Broadly speaking, Ofgem would expect that withdrawal criteria (i-iv) would prevail under any market circumstances and for the entire duration of the exemption. Criterion (v) might be relaxed for an initial period or for the entire period of the exemption the more it can be demonstrated that market conditions are and will remain effectively competitive. Ofgem would expect to set out with more clarity the circumstances and/or regularity (ie. whether or not there would be a periodic review) for considering these criteria, tailored to the circumstances of the facility in question. Ofgem would also expect that methods of gauging the criteria would remain stable over time.

5.54. This approach therefore accords with the idea that reopeners should as far as possible be linked to the actions of facility developers themselves, and so afford a degree of control and predictability to the facility developer.

5.55. In addition, withdrawals of exemptions resulting from reopeners could be partial or full. Alternatively, Ofgem may wish to make the continuation of an exemption contingent on certain undertakings by the infrastructure in question or may simply utilise other regulatory tools such as financial penalties under the Competition Act. The idea of partial withdrawals may also accommodate the grant of an exemption for different regulatory aspects. For example, Ofgem is willing to consider, as appropriate, granting a relatively certain exemption from rate of return regulation while potentially retaining greater powers to assess the withdrawal criteria for aspects of third party access. This approach was discussed in relation to UIOLI type arrangements.

5.56. To mitigate some of the uncertainties surrounding the withdrawal of an exemption, the DTI and Ofgem consider that any decision to withdraw an exemption would in most circumstances be the culmination of a review of the activities or assessment of the facility and would therefore be subject to sufficient transparency and consultation with facility operators and potential users.

5.57. It will be important to set out in advance how the withdrawal criteria for each facility will be assessed. Therefore, it is not possible to apply the withdrawal criteria in exactly the same manner to each facility. However, the case-by-case nature of exemptions necessarily requires potentially different approaches depending on the facility in question. For example, where the facility in question has the potential for a large market share that could raise competition concerns in future or has a relatively limited degree of third party access, then that facility may expect more frequent appraisal of particular withdrawal criteria. On the other hand, a facility that has demonstrated an effective third party access, had undertaken an effective “open season” or had a small market share, might expect less frequent review.

Timetable and consultation procedures

The DTI and Ofgem's initial view

5.58. The initial views paper set out Ofgem's intention to consult extensively where a particular project requested an exemption or early guidance. The paper also noted the need to consult appropriately with regulators at the non-GB end of an interconnector and to ensure an effective dialogue with the EU Commission prior to submitting an exemption decision for its consideration.

Views of respondents

5.59. Some respondents commented on in the issue of guidance letter prior to Ofgem receiving formal powers and that any formal exemption assessment would need to take appropriate account of the fact that significant sums of money may have been invested following the issuance of a comfort letter but prior to a formal exemption request.

5.60. A number of respondents stressed that it is vital that Ofgem consults extensively with market players over requests for exemptions. One respondent noted in particular that because of the dynamic nature of electricity and gas markets, such consultation is essential to ensure appropriate competition assessment. Another respondent queried whether a further round of consultation will take place once the necessary changes to GB law have been finalised.

5.61. Two respondents requested that a clear and consistent schedule of approvals be published, which incorporated Ofgem and Commission timetables, in order to avoid an open-ended process. Another requested that Ofgem identify the parties to be consulted and what timetables are considered necessary before routine granting of exemptions can be considered. One respondent argued that Ofgem's decisions on granting an exemption and any associated conditions should be subject to appeal to the Competition Commission.

The DTI and Ofgem's response

5.62. Regarding the timing of any regulatory guidance and formal exemption decisions, the DTI and Ofgem's aim is to manage the level of certainty and reduce regulatory risks that may surround this interim period prior to Ofgem receiving formal powers. However, while we shall aim to ensure, as far as possible, that any potential guidance that is issued gives comfort as to the likely regulatory treatment of particular infrastructure, any such guidance issued would also be constrained to a significant extent by necessary legal caveats. Subject to those legal caveats, we would wish that such a note would give some guidance to developers as to whether they might expect a formal exemption. If developers were concerned that any sunk investments would be disallowed from a formal assessment, this could risk delaying a number of projects until Ofgem received formal powers. However, developers are aware that a formal exemption cannot be awarded until Ofgem receives formal powers.

5.63. Concerning consultation timetables more generally, Ofgem has already published in September our initial views regarding GTS's draft exemption request for the BBL project. Given the nature of this projects as the first exemption request, the consultation period was set at four weeks.

6. Conclusions

6.1. This paper has set out the DTI and Ofgem's final views on the regulatory and exempt regime for interconnectors and LNG import terminals. The document explained why the DTI and Ofgem consider a licensing regime the most appropriate regulatory vehicle for interconnection activities. In addition, this document set out final views on the exemption criteria. The outcome of an assessment would be expected to influence the type of exemption granted, in terms of the parts of the regulated regime that were exempted; the duration of an exemption; and/or the manner or frequency with which withdrawal criteria are assessed.

6.2. In relation to the regulated regime the general preference would be for capacity to be auctioned, with the regulator approving ex-ante the terms of any auction. The regulated regime could however allow for capacity tariffs to be set and approved ex-ante to ensure that those tariffs met certain regulatory objectives, eg. non-discrimination.

6.3. In relation to other regulatory requirements, the DTI and Ofgem consider that the following features would be important for both the regulated and exempt regimes:

- **A requirement to initially offer capacity to market:** The regulated regime could provide for developers to secure initial contractual commitments, although bilateral negotiations would not fall under the definition of RTPA. It would be anticipated that loosening this requirement under the exempt regime would require Ofgem to consider the type of exemption granted to a facility and would of course have to be consistent with the exemption criteria, in particular the competition assessment.

- **Effective secondary trading and anti-hoarding mechanisms:** the DTI and Ofgem consider it important that some form of anti-hoarding mechanism is in place. For this reason, it will be a requirement for developers to adopt mechanisms that ensure that the maximum capacity at a facility is offered to market. Where these mechanisms are found not to be working, Ofgem would have to consider

withdrawing an exemption in all or in part, sufficient to address these concerns.

- **Information provision:** the DTI and Ofgem set out a number of information requirements. In general, any information published ex-post should not be a concern. More generally, information ex-ante should at least be made available to the regulator. In terms of publication of this information, the DTI and Ofgem would expect that there is equivalence in the information requirements for LNG and interconnectors as are required for example of generators in electricity or other connection points to the NTS in gas. In relation to upstream gas markets, the DTI and Ofgem anticipate completing a review of the level of transparency shortly. Therefore, to the extent to which greater transparency is required this will also be applied to LNG and gas interconnectors. To this end, LNG and interconnector developers should ensure that in their contracts with potential users that there are no contract provisions that prevent the operator publishing information to meet relevant legal or voluntary agreements going forward.

6.4. The DTI and Ofgem consider that it is important that the above conditions are met as they form an important part of the demonstration of sufficient competition and effective access to those facilities. These factors alongside the other Directive criteria will importantly impact on the nature of the exemption to be granted.

6.5. This paper has therefore set out a number of conditions for the default and exempt regime. As noted above, this provides a generic framework with which to assess particular projects. However, the specifics of the regulation of each facility may differ depending on the precise nature of the proposals. For this reason, the DTI and Ofgem attach significance to individual consultation on particular facilities.

6.6. It is important to note that the new EU legislation has not yet been implemented into GB law and that any amendments to GB law which are made in order to do so may be different to those currently envisaged. The views set out in this paper may change if the requisite amendments to GB law prove to be different to those envisaged. Interested parties should not rely on this document for any purpose other than as guidance as to the way

in which the new EU legislation may be transposed into GB law and views of how the new regulatory regime may operate.

Appendix 1 List of respondents to the consultation

1.1 The following parties responded to the May 2003 consultation document. Copies of these non-confidential responses can be viewed in Ofgem's library or on Ofgem's website (www.ofgem.gov.uk).

Association of Electricity Producers

BG Group

British Energy

Centrica

CREG

Professor David Newbery

Irish Dept. Communication Marine and Natural Resources

EDF Energy

Exxon Mobil International

Gastransport Services

Interconnector (UK)

National Grid Transco

Petroplus Tankstorage International

Powergen

Scottish and Southern Energy

Total Gas & Power

1.2 In addition to the above, there were a further five responses marked confidential.